

matched to the new hedged item, items, or aggregate risk under the principles of paragraph (b) of this section.

(8) *Unfulfilled anticipatory transactions*—(i) *In general.* If a taxpayer enters into a hedging transaction to reduce risk with respect to an anticipated asset acquisition, debt issuance, or obligation, and the anticipated transaction is not consummated, any income, deduction, gain, or loss from the hedging transaction is taken into account when realized.

(ii) *Consummation of anticipated transaction.* A taxpayer consummates a transaction for purposes of paragraph (e)(8)(i) of this section upon the occurrence (within a reasonable interval around the expected time of the anticipated transaction) of either the anticipated transaction or a different but similar transaction for which the hedge serves to reasonably reduce risk.

(9) *Hedging by members of a consolidated group*—(i) *General rule: single-entity approach.* In general, a member of a consolidated group must account for its hedging transactions as if all of the members were separate divisions of a single corporation. Thus, the timing of the income, deduction, gain, or loss on a hedging transaction must match the timing of income, deduction, gain, or loss from the item or items being hedged. Because all of the members are treated as if they were divisions of a single corporation, intercompany transactions are neither hedging transactions nor hedged items for these purposes.

(ii) *Separate-entity election.* If a consolidated group makes an election under § 1.1221-2(e)(2), then paragraph (e)(9)(i) of this section does not apply. Thus, in that case, each member of the consolidated group must account for its hedging transactions in a manner that meets the requirements of paragraph (b) of this section. For example, the income, deduction, gain, or loss from intercompany hedging transactions (as defined in § 1.1221-2(e)(2)(ii)) is taken into account under the timing rules of § 1.446-4 rather than under the timing rules of § 1.1502-13.

(iii) *Definitions.* For definitions of consolidated group, divisions of a single corporation, intercompany trans-

action, and member, see section 1502 and the regulations thereunder.

(iv) *Effective date.* This paragraph (e)(9) applies to transactions entered into on or after March 8, 1996.

(f) *Type or character of income and deduction.* The rules of this section govern the timing of income, deduction, gain, or loss on hedging transactions but do not affect the type or character of income, deduction, gain, or loss produced by the transaction. Thus, for example, the rules of paragraph (e)(3) of this section do not affect the computation of cost of goods sold or sales proceeds for a taxpayer that hedges inventory purchases or sales. Similarly, the rules of paragraph (e)(4) of this section do not increase or decrease the interest income or expense of a taxpayer that hedges a debt instrument or a liability.

(g) *Effective date.* This section applies to hedging transactions entered into on or after October 1, 1994.

(h) *Consent to change methods of accounting.* The Commissioner grants consent for a taxpayer to change its methods of accounting for transactions that are entered into on or after October 1, 1994, and that are described in paragraph (a) of this section. This consent is granted only for changes for the taxable year containing October 1, 1994. The taxpayer must describe its new methods of accounting in a statement that is included in its Federal income tax return for that taxable year.

[T.D. 8554, 59 FR 36358, July 18, 1994, as amended by T.D. 8653, 61 FR 519, Jan. 8, 1996; T.D. 8674, 61 FR 30138, June 14, 1996; T.D. 8985, 67 FR 12865, Mar. 20, 2002; 67 FR 31955, May 13, 2002]

§ 1.446-5 Debt issuance costs.

(a) *In general.* This section provides rules for allocating debt issuance costs over the term of the debt. For purposes of this section, the term *debt issuance costs* means those transaction costs incurred by an issuer of debt (that is, a borrower) that are required to be capitalized under § 1.263(a)-5. If these costs are otherwise deductible, they are deductible by the issuer over the term of the debt as determined under paragraph (b) of this section.

(b) *Method of allocating debt issuance costs*—(1) *In general.* Solely for purposes of determining the amount of debt

issuance costs that may be deducted in any period, these costs are treated as if they adjusted the yield on the debt. To effect this, the issuer treats the costs as if they decreased the issue price of the debt. See § 1.1273-2 to determine issue price. Thus, debt issuance costs increase or create original issue discount and decrease or eliminate bond issuance premium.

(2) *Original issue discount.* Any resulting original issue discount is taken into account by the issuer under the rules in § 1.163-7, which generally require the use of a constant yield method (as described in § 1.1272-1) to compute how much original issue discount is deductible for a period. However, see § 1.163-7(b) for special rules that apply if the total original issue discount on the debt is *de minimis*.

(3) *Bond issuance premium.* Any remaining bond issuance premium is taken into account by the issuer under the rules of § 1.163-13, which generally require the use of a constant yield method for purposes of allocating bond issuance premium to accrual periods.

(c) *Examples.* The following examples illustrate the rules of this section:

Example 1. (i) On January 1, 2004, X borrows \$10,000,000. The principal amount of the loan (\$10,000,000) is repayable on December 31, 2008, and payments of interest in the amount of \$500,000 are due on December 31 of each year the loan is outstanding. X incurs debt issuance costs of \$130,000 to facilitate the borrowing.

(ii) Under § 1.1273-2, the issue price of the loan is \$10,000,000. However, under paragraph (b) of this section, X reduces the issue price of the loan by the debt issuance costs of \$130,000, resulting in an issue price of \$9,870,000. As a result, X treats the loan as having original issue discount in the amount of \$130,000 (stated redemption price at maturity of \$10,000,000 minus the issue price of \$9,870,000). Because this amount of original issue discount is more than the *de minimis* amount of original issue discount for the loan determined under § 1.1273-1(d) (\$125,000 (\$10,000,000 × .0025 × 5)), X must allocate the original issue discount to each year based on the constant yield method described in § 1.1272-1(b). See § 1.163-7(a). Based on this method and a yield of 5.30%, compounded annually, the original issue discount is allocable to each year as follows: \$23,385 for 2004, \$24,625 for 2005, \$25,931 for 2006, \$27,306 for 2007, and \$28,753 for 2008.

Example 2. (i) Assume the same facts as in *Example 1*, except that X incurs debt issuance costs of \$120,000 rather than \$130,000.

(ii) Under § 1.1273-2, the issue price of the loan is \$10,000,000. However, under paragraph (b) of this section, X reduces the issue price of the loan by the debt issuance costs of \$120,000, resulting in an issue price of \$9,880,000. As a result, X treats the loan as having original issue discount in the amount of \$120,000 (stated redemption price at maturity of \$10,000,000 minus the issue price of \$9,880,000). Because this amount of original issue discount is less than the *de minimis* amount of original issue discount for the loan determined under § 1.1273-1(d) (\$125,000), X does not have to use the constant yield method described in § 1.1272-1(b) to allocate the original issue discount to each year. Instead, under § 1.163-7(b)(2), X can choose to allocate the original issue discount to each year on a straight-line basis over the term of the loan or in proportion to the stated interest payments (\$24,000 each year). X also could choose to deduct the original issue discount at maturity of the loan. X makes its choice by reporting the original issue discount in a manner consistent with the method chosen on X's timely filed federal income tax return for 2004. If X wanted to use the constant yield method, based on a yield of 5.279%, compounded annually, the original issue discount is allocable to each year as follows: \$21,596 for 2004, \$22,736 for 2005, \$23,937 for 2006, \$25,200 for 2007, and \$26,531 for 2008.

(d) *Effective date.* This section applies to debt issuance costs paid or incurred for debt instruments issued on or after December 31, 2003.

(e) *Accounting method changes—(1) Consent to change.* An issuer required to change its method of accounting for debt issuance costs to comply with this section must secure the consent of the Commissioner in accordance with the requirements of § 1.446-1(e). Paragraph (e)(2) of this section provides the Commissioner's automatic consent for certain changes.

(2) *Automatic consent.* The Commissioner grants consent for an issuer to change its method of accounting for debt issuance costs incurred for debt instruments issued on or after December 31, 2003. Because this change is made on a cut-off basis, no items of income or deduction are omitted or duplicated and, therefore, no adjustment under section 481 is allowed. The consent granted by this paragraph (e)(2) applies provided—

- (i) The change is made to comply with this section;
- (ii) The change is made for the first taxable year for which the issuer must account for debt issuance costs under this section; and
- (iii) The issuer attaches to its federal income tax return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

[T.D. 9107, 69 FR 464, Jan. 5, 2004]

§ 1.446-6 REMIC inducement fees.

(a) *Purpose.* This section provides specific timing rules for the clear reflection of income from an inducement fee received in connection with becoming the holder of a noneconomic REMIC residual interest. An inducement fee must be included in income over a period reasonably related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest.

(b) *Definitions.* For purposes of this section:

(1) *Applicable REMIC.* The applicable REMIC is the REMIC that issued the noneconomic residual interest with respect to which the inducement fee is paid.

(2) *Inducement fee.* An inducement fee is the amount paid to induce a person to become the holder of a noneconomic residual interest in an applicable REMIC.

(3) *Noneconomic residual interest.* A REMIC residual interest is a noneconomic residual interest if it is a noneconomic residual interest within the meaning of § 1.860E-1(c)(2).

(4) *Remaining anticipated weighted average life.* The remaining anticipated weighted average life is the anticipated weighted average life determined using the methodology set forth in § 1.860E-1(a)(3)(iv) applied as of the date of acquisition of the noneconomic residual interest.

(5) *REMIC.* The term REMIC has the same meaning in this section as given in § 1.860D-1.

(c) *General rule.* All taxpayers, regardless of their overall method of accounting, must recognize an inducement fee over the remaining expected life of the applicable REMIC in a man-

ner that reasonably reflects, without regard to this paragraph, the after-tax costs and benefits of holding that noneconomic residual interest.

(d) *Special rule on disposition of a residual interest.* If any portion of an inducement fee received with respect to becoming the holder of a noneconomic residual interest in an applicable REMIC has not been recognized in full by the holder as of the time the holder transfers, or otherwise ceases to be the holder for Federal tax purposes of, that residual interest in the applicable REMIC, then the holder must include the unrecognized portion of the inducement fee in income at that time. This rule does not apply to a transaction to which section 381(c)(4) applies.

(e) *Safe harbors.* If inducement fees are recognized in accordance with a method described in this paragraph (e), that method complies with the requirements of paragraph (c) of this section.

(1) *The book method.* Under the book method, an inducement fee is recognized in accordance with the method of accounting, and over the same period, used by the taxpayer for financial reporting purposes (including consolidated financial statements to shareholders, partners, beneficiaries, and other proprietors and for credit purposes), provided that the inducement fee is included in income for financial reporting purposes over a period that is not shorter than the period during which the applicable REMIC is expected to generate taxable income.

(2) *The modified REMIC regulatory method.* Under the modified REMIC regulatory method, the inducement fee is recognized ratably over the remaining anticipated weighted average life of the applicable REMIC as if the inducement fee were unrecognized gain being included in gross income under § 1.860F-2(b)(4)(iii).

(3) *Additional safe harbor methods.* The Commissioner, by revenue ruling or revenue procedure (see § 1.601(d)(2) of this chapter), may provide additional safe harbor methods for recognizing inducement fees relating to noneconomic REMIC residual interests.

(f) *Method of accounting.* The treatment of inducement fees is a method of accounting to which the provisions of sections 446 and 481 and the regulations